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Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-799

UNITED STATES OF AMERICA, *Petitioner,*

v.

FOSTER LUMBER COMPANY, INC., *Respondent*

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF THE NORTH RIVER INSURANCE COMPANY, AMICUS CURIAE, IN SUPPORT OF RESPONDENT

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INTEREST OF AMICUS CURIAE

The tax liability of amicus curiae The North River Insurance Company ("North River") will be directly affected by this Court's decision in the instant case. North River currently has pending before the Internal

Revenue Service claims for refund for certain taxable years which are based, in part, on the availability of net operating losses in a carryback year subsequent to a year in which the alternative tax is imposed. The Internal Revenue Service agent auditing the claims has stated his intention to disregard the holding of the court below, two other Courts of Appeals and the Tax Court, that net operating loss carrybacks are not absorbed by capital gains in alternative tax years.

Petitioner and Respondent have consented in writing to the filing of this Brief.

PURPOSE OF BRIEF

North River does not intend to reiterate the arguments contained in the Briefs of Respondent and amicus curiae Data Products Corporation that even if the term "taxable income" as used in the second sentence of section 172(b)(2) has the meaning given to it in section 63(a), as the government argues, the government's interpretation of the sentence as a whole is incorrect.[1] While we fully agree with the Eighth Circuit's construction of the sentence, and the arguments in support thereof presented by Respondent and Data Products, the purpose of this Brief is to show that affirmance of the court below is equally appropriate on the ground that, by definition, the term "taxable income" as used in section 172(b)(2) does not include capital gains in an alternative tax year.

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[1] The second sentence of section 172(b)(2) provides as follows:

"The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the *taxable income* for each of the prior taxable years to which such loss may be carried." (Emphasis supplied.)

ARGUMENT

The government argues that the term "taxable income" in section 172(b)(2) must mean total taxable income as defined in section 63(a). We strongly disagree. On the basis of other statutory provisions and established judicial authority, the "taxable income" of a corporation, as that term is used in section 172(b)(2), properly means, in an alternative tax year, only that taxable income which is subject to tax in the regular manner under section 11.

Section 11 provides as follows:

> "(a) CORPORATIONS IN GENERAL—A tax is hereby imposed for each taxable year on the *taxable income* of every corporation. The tax shall consist of a normal tax computed under subsection (b) [22% of all taxable income] and a surtax computed under subsection (c) [26% of taxable income over $25,000]." (Emphasis supplied.)

If a corporation has "net long-term capital gain in excess of net short-term capital loss," however, section 1201(a) may apply. During the years here involved, that section provided:

> ". . . in lieu of the tax imposed by [section] 11 . . . there is hereby imposed a tax (if such tax is less than the tax imposed by such [section]) which shall consist of the sum of—
>
> (1) a partial tax computed on the *taxable income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted,* and
>
> "(2) an amount equal to 25 percent of such excess . . . ." (Emphasis supplied.)

In *Chartier Real Estate Co.* v. *Commissioner,* 52 T.C. 346 (1969), aff'd., 428 F.2d 474 (1st Cir. 1970), the

government successfully persuaded the Tax Court that a net operating loss carryback could not be applied to reduce the long-term capital gain of a corporation in a carryback year if the section 1201 alternative tax is imposed for that year. The Tax Court upheld the government's position on the ground that section 1201 "creates an artificially separate tax on capital gains which ignores ordinary income and deduction" (52 T.C. at 357). Thus, by application of *Chartier,* with capital gains separated out and taxed on a flat, artificial basis, a loss carryback to an alternative tax year can only be applied against that reduced taxable income which is subject to tax in the regular manner under section 11.

Seeking to expand upon the *Chartier* result, the government here rejects the concept of a reduced taxable income for purposes of determining the amount of the carryback that is "absorbed" in an alternative tax year. The government contends (as it unsuccessfully contended in *Chartier*) that even though a loss carryback cannot be applied to reduce the capital gain that is separately taxed under section 1201 in the carryback year (thereby precluding the enjoyment of a tax benefit in such year), the term "taxable income" in section 172(b)(2) nevertheless should be construed so that the carryback is deemed to have been "absorbed" by the capital gain (thereby precluding the enjoyment of a tax benefit in later years as well).

The court below properly rejected this legalistic legerdemain. Rather, it correctly discerned that a loss carryback must be absorbed only by that "taxable income" which is subject to tax in the regular manner in an alternative tax year in order to give full effect to the benefits provided by Congress in both section 172 and section 1201.

A similar result was reached in *Merrill* v. *United States,* 105 F. Supp. 379 (Ct. Cl. 1952), where the Court of Claims interpreted the term "net income"—the 1939 Code term corresponding to the term "taxable income" used in the 1954 Code—to mean only that income subject to tax in the regular manner, i.e., income other than capital gain in an alternative tax year. The issue in *Merrill* involved an interpretation of the term "net income" as used in the then existing limitation on tax liability contained in section 12(g) of the 1939 Code—"90 per centum of the *net income* of the taxpayer." As here, the government contended that in an alternative tax year, the term was intended to include capital gains. The court rejected the government's contention, reasoning that to hold otherwise would have nullified the benefit Congress undertook to confer by means of the alternative tax on such gains. The court was influenced in reaching this result by the prior decisions of this Court in *Helvering* v. *Bliss,* 293 U.S. 144 (1934) and *Pleasants* v. *United States,* 305 U.S. 357 (1939), which, significantly, had reached precisely the opposite result in a different context. *Bliss* and *Pleasants* held that for purposes of computing the charitable contribution limitation, the term "net income" meant total net income, including capital gain, even in an alternative tax year.

The Court of Claims, in concluding that its decision in *Merrill* was completely consistent with the principles enunciated by this Court in *Bliss* and *Pleasants,* specifically cited the following passage in *Bliss* in support of its decision:

> "If the meaning of the Act were doubtful, we should still reach the same conclusion. The exemption of income devoted to charity and the reduction of the rate of tax on capital gains were liberal-

> izations of the law in the taxpayer's favor, were begotten from motives of public policy, and are not to be narrowly construed. Nor should the reduction in the rate of tax on capital gain, first granted in the Revenue Act of 1921, be held to circumscribe the privilege granted in the earlier Acts, and retained in later ones, with respect to charitable contributions, unless that result be plainly required by the language used. * * * " (293 U.S. at 150-151)

The Court of Claims properly construed this admonition as suggesting the necessity for an interpretation of the term "net income," in the context of the issue before it, which furthered, rather than frustrated, full enjoyment of the tax benefits intended by Congress. Since, as *Bliss* recognized, the alternative tax on capital gains is clearly a Congressionally intended benefit, and since the net operating loss provisions here involved also represent a clear liberalization of the law in the taxpayer's favor, begotten by strong policy considerations,[2] it is as appropriate here as it was in *Merrill* that the term "taxable income" be interpreted so as to exclude capital gains in an alternative tax year. To hold otherwise, as the government urges, would prevent an affected taxpayer from enjoying one or the other of those benefits solely because of accidents in timing.

Despite its assertion that the section 63(a) definition of "taxable income" applies to all provisions of the Internal Revenue Code from section 1 through section 1564, the government itself acknowledges that in

[2] The clear Congressional purpose to ameliorate the harsh consequences of the annual accounting period through the operation of section 172 is comprehensively developed in the Brief of Respondent.

some of those very provisions the term "taxable income" is given a meaning other than that provided in section 63(a). (G. Br. 18-19, n.9.) Specifically, the government refers this Court to section 832(a), dealing with non-life insurance companies such as North River. What the government fails to point out is that such companies are entitled to claim net operating loss deductions under section 172.[3] It is indisputable that the extent to which a loss carryback of such a company will be "absorbed" under section 172(b)(2) is determined, as the context requires, by reference to the company's "taxable income" as computed under section 832(a), not under section 63(a). Similarly, as applied in the context of the instant case, the term "taxable income" can and must be interpreted so as to give proper effect to the application of section 1201 in an alternative tax year.

The government next argues that if Congress had intended the term "taxable income" to be modified by the exclusion of long-term capital gains in an alternative tax year, there would have been an explicit modification to that effect contained in section 172(d). (G. Br. 18-19, n.9.) This argument plainly begs the question, since the modifications provided for in section 172(d) are modifications to whatever "taxable income" is encompassed by that term as it is intended to be used in the second sentence of section 172(b)(2). (Thus, there is no explicit modification in section 172(d) to accommodate the section 832(a) definition of "taxable income" applicable with respect to insurance companies such as North River.) If, as we contend, the term "taxable income" means, in the context of this case, only that taxable income which is subject to tax in the

[3] See section 832(c)(10).

regular manner under section 11, the capital gains in an alternative tax year are excluded by definition and no statutory modification is necessary.

The government also argues that if "taxable income" as used in section 172(b)(2) means only that taxable income which is subject to tax in the regular manner in an alternative tax year, then corporations would receive markedly better treatment than individuals. This argument is based on the erroneous assertion that the modification contained in section 172(d)(2)(B) requires an individual to "restore" 50 percent of his capital gains to taxable income, while no such requirement exists for corporations. Section 172(d)(2)(B), however, provides only that in the case of an individual taxpayer, "the [50 percent] deduction for long-term capital gains provided by section 1202 shall not be allowed." When section 1201 applies, the 50 percent deduction for capital gains under section 1202, which is allowed in a regular tax year, is automatically eliminated in the course of the alternative tax computation, and the capital gains of an individual (just like a corporation) are taxed *in full*.[4] Accordingly, no modification under section 172(d)(2)(B) is required in an alternative tax year, and no difference in treatment between individuals and corporations results if the term "taxable income" is construed as properly encompassing only that taxable income subject to tax in the regular manner in such a year.

[4] In *Mutual Assurance Society of Va. Corp.* v. *Commissioner*, 505 F.2d 128 (4th Cir. 1974), the only decision supporting the government's position on the meaning of "taxable income" in section 172(b)(2) as applied to corporate taxpayers, the majority was persuaded by an obviously erroneous interpretation of section 172(d)(2)(B), which it described as requiring an "addback" of the section 1202 deduction even in an alternative tax year. (505 F.2d at 135.)

The only case holding that an individual taxpayer's capital gain absorbs a net operating loss carryback under section 172(b)(2) in an alternative tax year is *Axelrod* v. *Commissioner*, 507 F.2d 884 (6th Cir. 1974). The Court in *Axelrod* was strongly influenced by the approach taken in *Mutual Assurance*, and assumed that its result was consistent with the treatment to be afforded corporations.

CONCLUSION

Where, as here, the benefits which Congress intended to confer under sections 172 and 1201 are so clearly established, this Court should adhere to the principles laid down in *Bliss* and *Pleasants*, as followed in *Merrill*, and interpret the term "taxable income" as used in section 172(b)(2) in a way that prevents the nullification of either of those benefits. For the reasons stated, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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